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Canada's Dairy Industry and the Implications of the WTO Dairy Dispute

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Report Highlights:
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CANADA'S DAIRY INDUSTRY AND THE IMPLICATIONS OF THE WTO DAIRY DISPUTE

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The Components of Canada's Dairy Industry

To combat unstable markets, uncertain supplies and varying returns to producers, the Canadian Dairy Commission (CDC) was created in 1966 and in the 1970's implemented a supply management program for the country's industrial milk production. That program has evolved into the Canadian dairy industry recognized today.

To control the amount of milk that is produced for sale in Canada, the Canadian Milk Supply Management Committee (CMSMC), under the direction of the CDC, calculates and recommends the national industrial milk production target, also known as Market Share Quota (MSQ). MSQ is calculated based on the previous year's domestic consumption, anticipated changes in demand, projected dairy stocks, import commitments, and export obligations. A safety margin, know as the sleeve, is added to the estimated MSQ, to absorb unexpected increases in demand.

Once the MSQ has been calculated, it is delegated to the provinces, and the provinces through their agencies and marketing boards, distribute the quota to individual producers. The amount of quota a producer owns determines the amount of milk the producer can sell for consumption. Quota can be bought, sold, or leased between holders; new entrants can enter the industry, but due to the high cost of quota, averaging between C$20,000 and $30,000, startup costs for a new dairy farmer may act as a significant barrier to entry.

Two Markets of Milk

The milk produced in Canada is used in two markets: fluid and industrial. Fluid milk, which accounts for approximately 40% of total production, is used for table milk and fresh cream. Industrial milk, which is approximately 60% of total production, is used for manufacturing dairy products such as cheese, butter and ice cream. Both fluid and industrial milk can be further divided into classes. Classes are determined based upon the amount of raw milk components and the end product from the dairy. In addition to the 3 classes of fluid milk and 9 classes of industrial milk, there are 4 special classes of milk. The price processors are charged for milk depends upon the class of milk they receive. Those components determine what product will be processed, and in turn what market the processor will serve.

The WTO Dispute

In 1997 the United States and New Zealand filed a complaint with the World Trade Organization (WTO) regarding Canadian dairy exports. The U.S. and New Zealand claimed that the lower price that processors paid for milk in Canada's special export class, versus the higher price processors paid for milk used in the domestic classes constituted an export subsidy, which put Canada over its WTO allowance for export subsidies. Canada argued that the reduced prices applied to exports were not an export subsidy.

In March 1999, the WTO ruled in favor of the U.S. and New Zealand, that Canada had been illegally exceeding its export subsidy reduction commitments, as agreed upon in the 1994

Uruguay Round, but Canada appealed the WTO decision. In October 1999, a dispute settlement panel upheld the U.S. challenge. Canada accepted the ruling and in December 1999, agreed to implement changes to its export program. Throughout 2000, the Government of Canada (GOC) and its dairy industry worked to develop a replacement program to comply with the WTO ruling.

By August 2000, the GOC had eliminated the Optional Export Program and one of its special export milk classes. Canada's federal government assisted the provincial governments in implementing new Commercial Export Milk (CEM) programs, but the U.S. and New Zealand were not satisfied that the new export programs were free of government involvement and in February 2001 returned to the WTO settlement dispute process. On April 12, 2001, the WTO compliance panel again ruled in favor of the U.S. and New Zealand, and Canada once again appealed.

In January 2002, the WTO Appellate Body ruled that the compliance panel used an incorrect price standard to analyze if there was a payment or not. The Appellate Body could not make a final ruling regarding the issue because it did not have the appropriate information. The U.S. and New Zealand asked the WTO to re-hear the case using the required data, and on June 24, 2002, the panel again ruled against Canada. Canada appealed and in December 2002, the WTO Dispute Settlement Body ruled in favor of the U.S. and New Zealand that the CEM program still constituted as a federal export subsidy. On May 9, 2003, Canada announced that it had entered into an agreement with the U.S. and New Zealand to settle the dispute resolution process.

The Compliance of Canada

Since May's settlement, in which Canada agreed to eliminate the illegal subsidies it was providing, Canada has been taking necessary steps to bring its dairy industry into compliance. In addition to ending its subsidized diary product exports to the U. S., and significantly limiting subsidized dairy exports destined for third country markets, Canada is implementing a new management plan for its milk supply. The new plan for the new dairy year, which started August 1st, will follow five principles: a zero minimal payment for over-quota milk at provincial levels to eliminate over quota production; no over-quota refunds at the end of the dairy year or another specified period; some consequence (decided by each province) for under-quota production; having the CMSMC's secretariat recommend an appropriate level of Plan A butter stocks so Canada can avoid importing butter; and having the secretariat recommend ways to ensure the industry achieves the appropriate level of Plan A butter stocks.

Conflict Within

When the WTO originally ruled that Canada's special export milk class constituted an export subsidy, the government run milk-marketing boards tried to propel the export program outside of the federal supply management system by delegating it to the provinces through the CEM. However some Canadian dairy farmers sold their quota and began producing milk for export-use only, outside of the domestic system, shipping their milk directly into the U.S. In December 2002, when the WTO ruled that the provincial CEM still constituted an export subsidy because it benefited from the higher priced domestic milk sales, their ruling didn't address the issue of non-quota holding producers.

Although the WTO didn't comment on non-holders of dairy quota, the provincial marketing board of Ontario did. Dairy Farmers of Ontario (DFO) determined that all Ontario dairy farmers needed to hold quota and had to be regulated within the supply management system for Ontario to stay within the allowed WTO limits on subsidized exports. Two Ontario groups of non-quota-holding dairy producers, including the Georgian Bay Milk Company (GBMC), had been exporting milk directly to the U.S. through a Canadian processor since June 2002, challenged the provincial decree. GBMC recently won a ruling from the Agriculture, Food and Rural Affairs Appeal Tribunal stating they did not have to purchase quota to export milk. The Dairy Farmers of Ontario appealed to Helen Johns, Ontario's Agriculture Minister to overturn the ruling, and in late July 2003 the ruling was overturned in favor of maintaining the integrity of Canada's national supply management system.

What Canada Wants

Since the Uruguay Round, Canada, the U.S., New Zealand and other countries have eased import restrictions on many products, including dairy. In recent years innovations in the use of dairy ingredients in food processing has resulted in some increased access for dairy imports into Canada. With the WTO rulings effectively curtailing the growth of Canada's export markets for manufactured dairy products, Canadian dairy producers are now more focused on maintaining their lucrative domestic market, at the expense of its export market.

The Effect on the World

Although the U.S. and New Zealand claimed victory in the suit against Canada, currently that victory amounts to little more than a change in the judicial process than it does in the production process. The milk sales affected by the WTO ruling accounted for about four percent of dairy production in Canada, and less than one percent of the volume of dairy products traded on international markets. However, the WTO ruling against Canada has settled the question of exactly what constitutes as an export subsidy, the appropriate prices for bench-marking cost of production data, and the hope that the ruling will serve to deter other countries from adopting similar export programs, undermining current world trade agreements.

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